

MSP
#1**The Complexity of the Tax Code****Definition of Problem**

The most serious problem facing taxpayers is the complexity of the Internal Revenue Code.

Analysis of Problem

The largest source of compliance burdens for taxpayers – and the IRS – is the overwhelming complexity of the tax code.¹ The only meaningful way to reduce these burdens is to simplify the tax code enormously.

Consider the following:

- According to a TAS analysis of IRS data, U.S. taxpayers and businesses spend about 7.6 billion hours a year complying with the filing requirements of the Internal Revenue Code.² And that figure does not even include the millions of additional hours that taxpayers must spend when they are required to respond to an IRS notice or an audit. (For a breakdown of hours by tax form and information reporting document, see Table 1.1.1 at the end of this section.)
- If tax compliance were an industry, it would be one of the largest in the United States. To consume 7.6 billion hours, the “tax industry” requires the equivalent of 3.8 million full-time workers.³
- Compliance costs are huge both in absolute terms and relative to the amount of tax revenue collected. Based on Bureau of Labor Statistics (BLS) data on the hourly cost of an employee, TAS estimates that the costs of complying with the individual and

¹ This report focuses on the impact of tax complexity on taxpayers. It should be noted that tax complexity also places a significant burden on the IRS as the tax administrator.

² The TAS Research function arrived at this estimate by multiplying the number of copies of each form filed in tax year 2006 by the average amount of time the IRS estimated it took to complete the form. While the IRS data is the most authoritative available, the amount of time the average taxpayer spends completing a form is difficult to measure with precision. TAS cannot determine the margin of error of existing estimates. Apart from the inherent imprecision of measuring time burdens for the “average” taxpayer, this TAS estimate may be low because it does not take into account all forms and it does not include the amount of time taxpayers spend responding to post-filing notices, examinations, or collection actions. Conversely, the TAS estimate may be high because IRS time estimates have not necessarily kept pace fully with technology improvements that allow a wider range of processing activities to be completed via automation. The TAS estimate includes both the time individual and business taxpayers spend filling out their tax returns and the time businesses spend generating information reporting documents like Forms W-2 and Forms 1099. Other published estimates generally have not included the time spent generating information reporting documents.

³ This calculation assumes each employee works 2,000 hours per year (i.e., 50 weeks, with two weeks off for vacation, at 40 hours per week).

corporate income tax requirements in 2006 amounted to \$193 billion – or a staggering 14 percent of aggregate income tax receipts.⁴

- Since the beginning of 2001, there have been more than 3,250 changes to the tax code, an average of more than one a day, including more than 500 changes in 2008 alone.⁵
- The Code has grown so long that it has become challenging even to figure out how long it is. A search of the Code conducted in the course of preparing this report turned up 3.7 million words.⁶ A 2001 study published by the Joint Committee on Taxation put the number of words in the Code at that time at 1,395,000.⁷ A 2005 report by a tax research organization put the number of words at 2.1 million, and notably, found that the number of words in the Code has *more than tripled* since 1975.⁸
- Tax regulations, which are issued by the Treasury Department to provide guidance on the meaning of the Internal Revenue Code, now stand about a foot tall.⁹ The CCH Standard Federal Tax Reporter, a leading publication for tax professionals that summarizes administrative guidance and judicial decisions issued under each section of the Code, now comprises 25 volumes and takes up nine feet of shelf space.¹⁰ Two companies publish newsletters *daily* that report on new developments in the field of

⁴ The IRS and several outside analysts have attempted to quantify the costs of compliance. For an overview of previous studies, see Government Accountability Office (GAO), GAO-05-878, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System* (Aug. 2005). There is no clearly correct methodology, and the results of these studies vary. All monetize the amount of time that taxpayers and their preparers spend complying with the Code. The TAS estimate of the cost of complying with individual and corporate income tax requirements (and thus excluding the time spent complying with employment, estate and gift, and excise tax requirements) was made by multiplying the total number of such hours (7.0 billion) by the average hourly cost of a civilian employee (\$27.54), as reported by the BLS. See BLS, U.S. Department of Labor, *Employer Costs for Employee Compensation – December 2006*, USDL: 07-0453 (Mar. 29, 2007) (including wages and benefits), at http://www.bls.gov/news.release/archives/ecec_03292007.pdf. The TAS estimate of compliance costs as a percentage of total income tax receipts for 2006 was made by dividing the income tax compliance cost as computed above (\$193 billion) by total 2006 income tax receipts (\$1.4 trillion). See Office of Management and Budget, *Budget of the United States Government – Fiscal Year 2009, Historical Tables, Table 2-1*. TAS's estimate that compliance costs amount to about 14 percent of aggregate income tax receipts falls within the range of previous estimates. For example, Professor Joel Slemrod has computed that compliance costs constitute about 13 percent of income tax receipts, while the Tax Foundation has computed that compliance costs constitute about 22 percent of income tax receipts. See Public Meeting of the President's Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Joel Slemrod, Paul W. McCracken Collegiate Professor of Business Economics and Public Policy, University of Michigan Stephen M. Ross School of Business), at <http://www.taxreformpanel.gov/meetings/meeting-03032005.shtml>; J. Scott Moody, Wendy P. Warcholik & Scott A. Hodge, *Special Report: The Rising Cost of Complying with the Federal Income Tax* (Tax Foundation, Dec. 2005), at <http://www.taxfoundation.org/research/show/1281.html>.

⁵ Unpublished CCH data provided to TAS.

⁶ To determine the number of words in the Internal Revenue Code, a librarian in the IRS Office of Chief Counsel downloaded a zipped file of Title 26 of the U.S. Code (i.e., the Internal Revenue Code) from the website of the U.S. House of Representatives at http://uscode.house.gov/download/title_26.shtml. She unzipped the file, copied it into Microsoft Word, and used the “word count” feature to compute the number of words. The version of Title 26 she used was dated Jan. 3, 2007, so the count does not reflect legislation passed during the 110th Congress. The Code contains certain information, such as a description of amendments that have been adopted, effective dates, cross references, and captions, that do not have the effect of law. It is possible that other attempts to determine the length of the Code have attempted to exclude some or all of these components, but there is no clearly correct methodology to use, and there is no easy way to selectively delete information from a document of this length.

⁷ See Staff of the Joint Committee on Taxation, 107th Cong., *Study of the Overall State of the Federal Tax System and Recommendations for Simplification*, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (vol. I), at 4 (Comm. Print 2001).

⁸ J. Scott Moody, Wendy P. Warcholik & Scott A. Hodge, *Special Report: The Rising Cost of Complying with the Federal Income Tax* (Tax Foundation, Dec. 2005), at <http://www.taxfoundation.org/research/show/1281.html>.

⁹ See CCH Income Tax Regulations (which runs 11,700 pages in six volumes) or RIA Federal Tax Regulations (which runs five volumes).

¹⁰ CCH Standard Federal Tax Reporter (2008).

taxation; the print editions often run 50-100 pages and the electronic databases contain substantially more detailed information.¹¹

- The complexity of the Code leads to perverse results. On the one hand, taxpayers who honestly seek to comply with the law often make inadvertent errors, causing them either to overpay their tax or to become subject to IRS enforcement action for mistaken underpayments of tax. On the other hand, sophisticated taxpayers often find loopholes that enable them to reduce or eliminate their tax liabilities.
- Individual taxpayers find the return preparation process so overwhelming that more than 80 percent pay transaction fees to help them file their returns. About 60 percent¹² pay preparers to do the job,¹³ and another 22 percent purchase tax software to help them perform the calculations themselves.¹⁴
- The Code contains no comprehensive Taxpayer Bill of Rights that explicitly and transparently sets out taxpayer rights and obligations.¹⁵ Taxpayers do have rights, but they are scattered throughout the Code and the Internal Revenue Manual and are neither easily accessible nor written in plain language that most taxpayers can understand.¹⁶

The Office of the Taxpayer Advocate sees dozens of examples of the impact of tax law complexity each year. Here are some key illustrations:

- ***Excessive Number of Education and Retirement Savings Incentives.*** The Code currently contains at least 11 incentives to encourage taxpayers to save for and spend on education; the eligibility requirements, definitions of common terms, income-level thresholds, phase-out ranges, and inflation adjustments vary from provision to

¹¹ These publications are *Highlights & Documents* (published by Tax Analysts) and the *Daily Tax Report* (published by BNA). According to the Federal Editor in Chief of Tax Analysts, *Tax Notes Today* (the electronic publication that serves as the main source for stories in *Highlights & Documents*) contains an average of 50-70 items a day.

¹² Among unincorporated business taxpayers, about 74 percent use preparers. IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006).

¹³ In tax year 2007, about 62 percent of returns were prepared by preparers. IRS Compliance Data Warehouse, Individual Returns Transaction File (tax year 2007). To complete the percentage prepared for a fee, we subtracted the number of returns prepared by Volunteer Income Tax Assistance (VITA) sites.

¹⁴ The number of individual taxpayers who purchase tax software was computed by starting with the number of On-Line File and Self V-Code returns (33.2 million), subtracting the number of Free File returns (3.9 million), and dividing the result (29.3 million) by the total number of returns (134.4 million). IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008); 2007 Free File Weekly Snapshot Report Week 40. This data relates to Tax Year 2006.

¹⁵ Congress has enacted several pieces of legislation that bear the title, "Taxpayer Bill of Rights," but those pieces of legislation contain discrete provisions rather than an overarching list of core rights. See Technical and Miscellaneous Revenue Act, Pub. L. No. 100-647 (1988) (containing the Omnibus Taxpayer Bill of Rights, also known as "TBOR 1"); Taxpayer Bill of Rights 2, Pub. L. No. 104-168 (1996) (also known as "TBOR 2"); and Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206 (1998) (containing the Taxpayer Bill of Rights 3, also known as "TBOR 3").

¹⁶ The National Taxpayer Advocate has previously recommended that Congress enact a Taxpayer Bill of Rights that sets out taxpayer rights and obligations. See National Taxpayer Advocate 2007 Annual Report to Congress 478-89 (Legislative Recommendation: *Taxpayer Bill of Rights and De Minimis "Apology" Payments*).

provision.¹⁷ The Code also contains at least 16 incentives to encourage taxpayers to save for retirement; these incentives are subject to different sets of rules governing eligibility, contribution limits, taxation of contributions and distributions, withdrawals, availability of loans, and portability.¹⁸ Taxpayers wishing to choose the optimal vehicle to save for college must know the difference between a Section 529 plan, a Coverdell Education Savings Account, and the Hope and Lifetime Learning Credits, among other alternatives. Taxpayers wishing to choose the optimal plan in which to save for retirement must know the difference between a traditional IRA, a Roth IRA, a Section 401(k) plan, a Section 403(b) plan, and a SARSEP, among others.

The point of a tax incentive, almost by definition, is to encourage certain types of economic behavior. But taxpayers can only respond to incentives if they know they exist and understand them. Choice is good, but too much choice is overwhelming. It is not reasonable to expect the average taxpayer to learn the details of at least 27 education and retirement incentives to determine which ones provide the best fit.¹⁹

- **The Alternative Minimum Tax (AMT).** The AMT concept, originally enacted in response to a report that 155 high-income taxpayers had paid no tax for the 1966 tax year,²⁰ now effectively requires taxpayers to compute their taxes twice – once under the regular rules and again under the AMT regime – and then to pay the higher of the two amounts.²¹ The AMT was originally conceived to prevent wealthy taxpayers from escaping tax liability through the use of tax-avoidance transactions. However, most of the significant tax loopholes that enabled taxpayers to escape tax at the time the AMT was written have long since been closed, and it is now estimated that about 77 percent of the additional income subject to tax under the AMT is attributable simply to family

¹⁷ Tax benefits for past educational expenses include the deduction for interest on education loans in IRC § 221 and an income exclusion for the cancellation of student loan debt in IRC § 108(f). Tax incentives for current expenses include the Hope and Lifetime Learning Credits in IRC § 25A, the above-the-line deduction for qualified tuition and related deductions in IRC § 222, the income exclusion for qualified scholarships in IRC § 117, and the income exclusion for employer education assistance programs in IRC § 127. Tax incentives for future education expenses include the exclusion of interest income from U.S. Savings Bonds used to pay education tuition and fees in IRC § 135, the income exclusion for early distributions to pay qualified higher education expenses from Roth IRAs in IRC § 408A, Qualified Tuition Programs in IRC § 529, and Coverdell Education Savings Accounts in IRC § 530.

¹⁸ Types of retirement plans available under the Internal Revenue Code include traditional IRAs, nondeductible IRAs, nonworking spousal IRAs, Roth IRAs, rollover IRAs, Savings Incentive Match Plan for Employees (SIMPLE) IRAs, IRC § 401(k) plans, profit-sharing plans, money purchase plans, employer-funded defined benefit plans for private employers, Simplified Employee Pensions (SEPs), Salary Reduction Simplified Employee Pension Plans (SARSEPs), SIMPLE 401(k) plans used by small employers, IRC § 403(b) tax-sheltered annuity plans for IRC § 501(c)(3) organizations and public schools, IRC § 414(d) governmental plans, and IRC § 457(b) deferred compensation plans for state and local governments.

¹⁹ This report contains legislative recommendations to streamline the multitude of education and retirement incentives. See Legislative Recommendation, *Simplify and Streamline Education Tax Incentives*, and Legislative Recommendation, *Simplify and Streamline Retirement Savings Tax Incentives*, *infra*. For more detailed recommendations proposed in a prior report, see National Taxpayer Advocate 2004 Annual Report to Congress 403-22 (Key Legislative Recommendation, *Simplification of Provisions to Encourage Education*) and National Taxpayer Advocate 2004 Annual Report to Congress 423-32 (Key Legislative Recommendation, *Simplification of Provisions to Encourage Retirement Savings*).

²⁰ Congress acted after learning that 155 taxpayers with adjusted gross incomes above \$200,000 had paid no federal income tax for the 1966 tax year. See *The 1969 Economic Report of the President: Hearings Before the Joint Economic Comm.*, 91st Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury). The forerunner of the AMT was an "add-on" minimum tax enacted in 1969.

²¹ The AMT rules are contained in IRC §§ 55-59.

size or residing in a high-tax state.²² Few people think of having children or living in a high-tax state as a tax avoidance maneuver, but under the unique logic of the AMT, that is how those actions are treated. Yet government has become so dependent on AMT revenue that Congress to date has been unwilling to make permanent changes in law to curtail the AMT, and it is not likely that such changes will be made outside the context of major tax reform.²³

- **Tax Consequences of Mortgage Foreclosures and Canceled Debts.** Most financially distressed individuals who lose their homes to foreclosure or cannot pay off their car loans, credit card balances, student loans, or medical bills probably do not realize that their delinquency may increase their tax liabilities, but it often does. If a creditor writes off a debt, the tax code generally treats the amount of the canceled debt as taxable income to the debtor.²⁴ Congress has carved out a number of exclusions, including a recently enacted exclusion to help homeowners whose mortgage debts are canceled when their houses are foreclosed upon and sold.²⁵ However, taxpayers do not receive the benefit of these exclusions automatically. A taxpayer must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, to claim an exclusion. Form 982 is extremely complex, and very few taxpayers or preparers are familiar with it. The IRS estimates that it takes business taxpayers ten hours and 43 minutes to complete the form,²⁶ and the form is not included in many tax software packages available to taxpayers.

IRS data shows that approximately two million Forms 1099-C, *Cancellation of Debt*, are issued to taxpayers each year reporting canceled debts.²⁷ The National Taxpayer Advocate estimates that tens of thousands and possibly hundreds of thousands of taxpayers who qualify to exclude canceled debts from gross income

²² See Tax Policy Center, *Tax Facts: AMT Preference Items 2002, 2004-2006* (citing unpublished tabulations from the Office of Tax Analysis, Department of the Treasury), at http://www.taxpolicycenter.org/taxfacts/Content/PDF/amt_preference.pdf. With respect to personal exemptions, the AMT disallows the personal exemptions that are allowed under the regular tax rules to reflect the additional costs of maintaining a household and raising a family. With respect to state and local taxes, the AMT disallows the deduction for the payment of state and local income, sales, and property taxes that taxpayers are allowed to claim under the regular tax rules to reduce "double taxation" at the federal and state levels on the same income.

²³ This report contains a legislative recommendation to repeal the AMT. See Legislative Recommendation, *Repeal the Alternative Minimum Tax for Individuals*, *infra*. The National Taxpayer Advocate has repeatedly identified the AMT as a serious problem for taxpayers and has recommended its repeal in prior reports and congressional testimony. See National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem, *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2004 Annual Report to Congress 383-85 (Key Legislative Recommendation, *Alternative Minimum Tax*); National Taxpayer Advocate 2003 Annual Report to Congress 5-19 (Most Serious Problem, *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2001 Annual Report to Congress 166-77 (Key Legislative Recommendation, *Alternative Minimum Tax for Individuals*); see also *Alternative Minimum Tax: Hearing Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways & Means* (Mar. 7, 2007) (statement of Nina E. Olson, National Taxpayer Advocate); *Blowing the Cover on the Stealth Tax: Exposing the Individual AMT: Hearing Before the Subcomm. on Taxation and IRS Oversight of the Senate Comm. on Finance* (May 23, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

²⁴ IRC § 61(a)(12).

²⁵ IRC § 108(a)(1).

²⁶ The IRS does not provide a separate estimate of the amount of time individual taxpayers spend completing Form 982.

²⁷ IRS Document 6961, Table 2 (showing that the IRS expects to receive about 1.9 million Forms 1099-C in 2008 and about 2.1 million Forms 1099-C in 2009).

do not file Form 982 to claim allowable exclusions.²⁸ Instead, some of these taxpayers unnecessarily include the amount of the canceled debt in gross income, and other taxpayers who fail to include it unnecessarily face IRS examinations and tax assessments.²⁹

- **Earned Income Tax Credit (EITC) Complexity.** About 22 million low income taxpayers claim the EITC each year.³⁰ The eligibility requirements and computations are complex, yet EITC recipients are relatively less able to understand complex rules and less likely to speak English as their primary language, creating a recipe for confusion.³¹ EITC complexity leads to improper claims by taxpayers – some intentional but many inadvertent – and to improper denials by the IRS. A 2004 TAS study surveyed cases in which the IRS denied an EITC claim on audit but the taxpayer asked the IRS to reconsider its findings. Despite the initial IRS denials, the study found that taxpayers ultimately obtained some or all of the EITC amount they had claimed on their returns in 43 percent of the cases (and they received, on average, 94 percent of the amount they had originally claimed).³²

Another window into EITC complexity: One might expect that low income taxpayers would be less likely to need return preparers because their sources of income are often limited to wages and perhaps interest income, yet 72.5 percent of taxpayers who claim the EITC use tax preparers.³³

- **Proliferating Tax Sunsets.** The tax code contains more than 100 provisions that are temporary and set to expire soon, up from about 21 in 1992. Tax benefits have increasingly been enacted for a limited number of years in order to reduce their cost for budget-scoring purposes. Although most such benefits are periodically renewed, some are not. For example, the AMT patch and the deductions for state and local taxes and for tuition and fees paid to a post-secondary institution are generally renewed for one or two years at a time, but the extensions are not guaranteed and the amount of the AMT patch is generally changed with each renewal. If taxpayers do not know whether

²⁸ This report identifies the tax treatment of canceled debts as one of the most serious problems facing taxpayers and contains a legislative recommendation designed to ensure that more taxpayers who are entitled to exclusions are able to obtain them. See Most Serious Problem, *Understanding and Reporting the Tax Consequences of Cancellation of Debt Income*, and Legislative Recommendation, *Simplify the Tax Treatment of Cancellation of Debt Income*, *infra*. The National Taxpayer Advocate also identified the tax treatment of canceled debts as a serious problem in her 2007 report. See National Taxpayer Advocate 2007 Annual Report to Congress 13-34 (Most Serious Problem, *Tax Consequences of Cancellation of Debt Income*).

²⁹ The IRS receives Forms 1099-C, *Cancellation of Debt*, from lenders reporting the amount of each canceled debt. The IRS document-matching program compares each Form 1099-C it receives against the tax return of the taxpayer with the same taxpayer identification number. If a canceled debt is reported to the IRS on Form 1099-C and the amount is not reported on the taxpayer's return, the discrepancy will be flagged and the taxpayer may face IRS examination and tax assessment.

³⁰ IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006).

³¹ This report contains a recommendation to restructure and simplify the family status provisions in the Code, including the EITC. See Legislative Recommendation, *Simplify the Family Status Provisions*, *infra*. For a previous recommendation to simplify the family status provisions in the Internal Revenue Code, see National Taxpayer Advocate 2005 Annual Report to Congress 397-406 (Key Legislative Recommendation, *Tax Reform for Families: A Common Sense Approach*).

³² National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2 (Research Report, *Earned Income Tax Credit (EITC) Audit Reconsideration Study*).

³³ IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006).

a tax benefit will remain in the Code, the incentive is less likely to influence their decision-making, thereby undermining its purpose. The uncertainty associated with an expiring tax benefit also makes it difficult for taxpayers to estimate their tax liabilities and pay the correct amount of estimated tax, potentially subjecting them to penalties and causing disillusionment with the tax system.³⁴

- **Phase-out Complexity.** More than half of all individual income tax returns filed each year are affected by the phase-out of certain tax benefits. A common phase-out relates to the deduction allowed for personal exemptions. For example, a married couple with two minor children is generally allowed to claim four personal exemptions if they file a joint return, with each deduction worth \$3,500 (\$14,000 in the aggregate) in tax year 2008.³⁵ If the family's adjusted gross income (AGI) exceeds a certain threshold, however, the exemption amount is phased out at a rate of two percentage points for each additional \$2,500 (or fraction thereof) of income. Thus, under permanent law, the benefits of the personal exemptions would fully phase out over a \$125,000 income range. But under a temporary provision that will sunset after 2009, the phase-out is capped at one-third of the exemption amount. Thus, the phase-out may not reduce the exemption amount below \$2,333 per family member (\$9,332 in the aggregate).³⁶ This computation is not obvious to the average taxpayer, and as noted, there are about 100 phase-outs that operate in this manner. Like tax sunsets, phase-outs are largely used to reduce the cost of tax provisions for budget-scoring purposes. However, phase-outs add substantial complexity and create marginal "rate bubbles" – income ranges within which an additional dollar of income earned by a relatively low income taxpayer is taxed at a higher rate than an additional dollar of income earned by a relatively high income taxpayer. This inequity is largely hidden by the complexity of the phase-out calculations.³⁷
- **Unclaimed Telephone Excise Tax Refunds.** In 2006, taxpayers were permitted to claim a one-time tax credit for telephone excise taxes that the government concluded it had improperly collected in the past.³⁸ The amount of the credit ranged from \$30 to \$60, depending on the number of personal exemptions the taxpayer was entitled to claim on the return.³⁹ No substantiation was required unless a taxpayer claimed a larger amount, so this credit was essentially free money. Yet IRS data show that 28 percent of eligible taxpayers (37 million out of 133.2 million) did not claim the credit.⁴⁰ The only

³⁴ This report contains a legislative recommendation to reduce the procedural incentives for Congress to enact tax sunsets. See Legislative Recommendation, *Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets*, *infra*.

³⁵ IRC § 151(d).

³⁶ See IRS Form 1040 Instructions at 36 (2008).

³⁷ This report contains a legislative recommendation to reduce the number of phase-outs in the Internal Revenue Code. See Legislative Recommendation, *Eliminate (or Simplify) Phase-Outs*, *infra*. To the extent that phase-outs are intended to increase the tax burden on higher income taxpayers, the same result can be achieved by adjusting the marginal tax rates, a more straightforward approach that is simpler and avoids the problem of marginal rate bubbles.

³⁸ See IRS Notice 2006-50, 2006-1 C.B. 1141. Unlike the other examples cited in this section, the telephone excise tax refunds were authorized by the Department of the Treasury and did not involve congressional action.

³⁹ IRS News Release, *IRS Announces Standard Amounts for Telephone Tax Refunds*, IR-2006-137 (Aug. 31, 2006).

⁴⁰ IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008).

plausible explanation is that taxpayers missed the credit because of the complexity of the law and the tax forms.⁴¹

- **Burgeoning Penalties.** The number of civil penalties in the Code has grown from about 14 in 1954 to approximately 130 today.⁴² Penalties should be designed to enhance voluntary tax compliance, but they also should be reasonable and can only influence future taxpayer behavior if taxpayers are aware that the penalties exist. As a consequence of “penalty creep,” some penalties are obscure or unduly harsh. For example, Section 6707A of the Code, which was enacted in 2004 to combat tax shelters, imposes a minimum penalty of \$100,000 per individual per year and \$200,000 per entity per year for a failure to disclose a “listed transaction.”⁴³ The penalty reflects strict liability – the IRS must impose the penalty even if the taxpayer derived little or no tax benefit, even if the taxpayer had no reason to know the transaction was questionable, and even if the transaction was not “listed” until years after the taxpayer’s return was filed and the transaction was complete. Taxpayers cannot challenge this penalty in court. As a result, an individual who does business as an S corporation and who entered into a transaction that he did not know was listed and that provided little or no tax savings would face an automatic \$300,000 penalty per year. In addition, the usual three-year statute of limitations on tax assessments does not apply in the case of listed transactions,⁴⁴ so if the taxpayer entered into a listed transaction that was reflected on his return for ten years, he would face an automatic \$3 million penalty overall. TAS has about 40 cases in its inventory involving non-rescindable Section 6707A penalties,⁴⁵ and we understand the IRS is considering this penalty in hundreds of additional cases. If Congress does not change the law quickly, this penalty may bankrupt middle-class families that had no intention of entering into a tax shelter.⁴⁶
- **Small Business Burdens.** Small business taxpayers face a particularly bewildering array of laws, including a patchwork set of rules that governs the depreciation of equipment, numerous and overlapping filing requirements for employment taxes, and a vague set of factors that govern the classification of workers as either employees or independent contractors and that can keep businesses and the IRS battling each other for years with no obvious “correct” answer.⁴⁷

⁴¹ One might assume that tax preparers would know about the credit. Yet IRS data show that 16 percent of practitioner-prepared returns failed to claim the credit as well. IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008).

⁴² This estimate excludes criminal penalties and certain excise tax penalties. For a list of penalties and additional information about how the list was compiled, see *A Framework for Reforming the Penalty Regime*, in volume 2 of this report.

⁴³ IRC § 6707A.

⁴⁴ IRC § 6501(c)(10).

⁴⁵ TAS, Taxpayer Advocate Management Information System (keyword and history search performed in December 2008).

⁴⁶ This report contains a legislative recommendation to modify IRC § 6707A to mitigate the harsh results the penalty can produce. See Legislative Recommendation, *Modify Internal Revenue Code § 6707A to Ameliorate Unconscionable Impact*, *infra*. This report also contains a comprehensive set of recommendations to simplify the penalty provisions of the Code overall. See Legislative Recommendation, *Reforming the Penalty Regime*, *infra*, and an accompanying study, *A Framework for Reforming the Penalty Regime*, in volume 2 of this report.

⁴⁷ This report contains a legislative recommendation to simplify worker classification determinations. See Legislative Recommendation, *Worker Classification*, *infra*. In addition, the National Taxpayer Advocate previously proposed a package of legislative recommendations designed reduce the tax burdens on small business. See National Taxpayer Advocate 2004 Annual Report to Congress 386-402 (Key Legislative Recommendation, *Small Business Burdens*).

Recommendation

The National Taxpayer Advocate recommends that Congress substantially simplify the Internal Revenue Code.

America's taxpayers deserve a simpler and less burdensome tax system that enables them to comply with their tax obligations expeditiously – not one that requires them to spend 7.6 billion hours filing their returns every year, thereby consuming the equivalent of 3.8 million full-time workers. Taxpayers deserve a tax system that enables them to prepare their returns cheaply – not one that requires them to pay practitioners for help, as nearly 61 percent of individual taxpayers and 74 percent of unincorporated business taxpayers do today. Taxpayers deserve more clarity about their rights and obligations under the tax code in the form of a Taxpayer Bill of Rights. Taxpayers deserve a tax system that enables them to make wise choices about education and retirement savings – without having to wade through the details of at least 27 tax-favored alternatives. Taxpayers deserve a tax system that enables them to compute their tax liabilities fairly and transparently – not one that effectively requires them to compute their tax liability under two sets of rules (the regular rules and the AMT rules) and often to pay more tax under the AMT regime simply because they engaged in the “tax-avoidance behavior” of having children or living in a high-tax state.

Taxpayers deserve better than a tax system so complex that honest taxpayers often overpay while sophisticated taxpayers often find loopholes, and so complex that 37 million taxpayers could fail to claim a tax credit because they did not know it was available. Taxpayers deserve better than a tax system that gives financially distressed taxpayers a tax break when they default on their mortgage or other consumer debts and the debts are cancelled – but then makes claiming the tax break so burdensome that many and probably most eligible taxpayers do not claim it. Low income taxpayers deserve a simpler set of rules by which determine EITC eligibility.

Taxpayers deserve certainty about which provisions will remain in the tax code so they can plan accordingly – without having to regularly grapple with uncertainty because more than 100 provisions sunset regularly and may or may not be renewed or modified. Taxpayers deserve to understand exactly how their tax liabilities are computed – not provisions like phase-outs, which make the computations seem impenetrable and subject lower income taxpayers to higher marginal tax rates than upper income taxpayers. Taxpayers deserve simplicity and proportionality in the penalty rules; it is not reasonable that a taxpayer who claims minimal or even no tax savings may face a mandatory, non-waivable \$300,000 penalty per year for failing to file a disclosure form that he may not even know he is required to file.

These are a few aspects of a system that requires pervasive reform. The good news is that there is widespread agreement on the need for tax simplification. The National Taxpayer Advocate has previously identified the complexity of the tax code as the most serious

problem facing taxpayers,⁴⁸ members of Congress regularly complain about the complexity of the Code, and in 2005, an advisory panel created by President Bush to study the federal tax system delivered a detailed report with substantive recommendations.⁴⁹ The bad news is that despite widespread agreement on the need for tax simplification, there has not yet been sustained action to make it happen.

To assist the Congress in pursuing tax simplification, we offer a number of proposals in the Legislative Recommendations section of this report, including recommendations to streamline the education and retirement savings incentives, repeal the AMT, allow taxpayers to exclude modest amounts of canceled debts from income without filing Form 982, simplify the family status provisions of the Code, reduce tax sunset and phase-out provisions, and revise the penalty structure.

The National Taxpayer Advocate continues to view tax simplification as essential and urges the new administration and the new Congress to make it a priority. In doing so, she recommends that emphasis be given to six core principles:

1. The tax system should not “entrap” taxpayers.
2. The tax laws should be simple enough so that most taxpayers can prepare their own returns without professional help, simple enough so that taxpayers can compute their tax liabilities on a single form, and simple enough so that IRS telephone assistants can fully and accurately answer taxpayers’ questions.
3. The tax laws should anticipate the largest areas of noncompliance and minimize the opportunities for such noncompliance.
4. The tax laws should provide some choices, but not too many choices.
5. Where the tax laws provide for refundable credits, they should be designed in a way that is administrable; and
6. The tax system should incorporate a periodic review of the tax code – in short, a sanity check.⁵⁰

⁴⁸ See National Taxpayer Advocate 2004 Annual Report to Congress 2-7 (Most Serious Problem, *The Confounding Complexity of the Tax Code*).

⁴⁹ Report of the President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System* (Nov. 2005), at www.taxreformpanel.gov.

⁵⁰ The National Taxpayer Advocate previously articulated these principles in a presentation to the President’s Advisory Panel on Federal Tax Reform. See Public Meeting of the President’s Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Nina E. Olson, National Taxpayer Advocate), at <http://www.taxreformpanel.gov/meetings/meeting-03032005.shtml>. For more detail, see National Taxpayer Advocate 2005 Annual Report to Congress 375-80 (Key Legislative Recommendation, *A Taxpayer-Centric Approach to Tax Reform*).

TABLE 1.1.1, Hours Required to Prepare Tax Returns and Information Reporting Documents

Type of Return	Number (in millions)	Average Total Hours/Minutes	Total Hours (in millions)
Tax Returns			
Individual Income Tax (1040)	134.6	26.40	3,553.44
Estate and Trust Income Tax (1041)	3.6	116.27	418.56
Estate and Trust Est'd Tax (1041-ES)	0.7	3.28	2.30
Partnerships (1065)	3.0	126.75	380.25
Electing Large Partnerships (1065-B)	0.0001	113.95	0.01
S Corporations (1120S)	3.9	145.97	569.27
Corporations (1120)	1.8	193.77	348.78
1066	0.03	54.25	1.63
1120-A	0.2	115.08	23.02
1120-C	0.001	107.60	0.11
1120-F	0.02	222.45	4.45
1120-FSC	0.006	152.90	0.92
1120-H	0.2	32.62	6.52
1120-L	0.001	178.20	0.18
1120-PC	0.006	212.33	1.27
1120-POL	0.005	36.62	0.18
1120-REIT	0.01	130.37	1.30
1120-RIC	0.009	118.15	1.06
Estate Tax (706)	0.5	7.75	3.88
Gift Tax (709)	0.2	5.77	1.15
Employment Tax (940 series)	6.0	37.32	223.92
Employment Tax (941 series)	24.0	15.40	369.60
Tax-Exempt Organizations (990)	0.4	152.33	60.93
Excise Tax (720) (data from 10/2008)	0.1	28.67	2.87
Form 1040X (data from 11/07/2006)	3.7	3.50	12.95
Tax Returns Subtotal			5,988.56

Information Reporting	Number (in millions)	Average Total Hours/Minutes	Total Hours (in millions)
W-2	243.3	0.50	121.65
K-1 (1041)	3.5	12.47	43.63
K-1 (1065)	17.8	45.87	816.49
K-1 (1120S)	6.7	42.03	281.62
1096	5.6	0.22	1.21
1098	105.2	0.12	12.27
1098-C	0.2	0.25	0.05
1098-E	18.2	0.12	2.12
1098-T	24.2	0.22	5.24
1099-A	0.5	0.15	0.08
1099-B	538.1	0.33	179.37
1099-C	1.7	0.17	0.28
1099-CAP	0.002	0.18	0.00
1099-DIV	103	0.30	30.90
1099-G	72.7	0.18	13.33
1099-H	0.02	0.30	0.01
1099-INT	231.7	0.22	50.20
1099-LTC	0.2	0.22	0.04
1099-MISC	83.5	0.27	22.27
1099-OID	4.1	0.20	0.82
1099-PATR	1.6	0.25	0.40
1099-Q	1.0	0.18	0.18
1099-R	76.3	0.30	22.89
1099-S	4.2	0.13	0.56
1099-SA	1.0	0.13	0.13
5498	108.5	0.20	21.70
5498-ESA	0.8	0.12	0.09
5498-SA	1.4	0.17	0.23
W2-G	9.7	0.30	2.91
Information Returns Subtotal			1,630.69
Grand Total			7,619.25

Except as noted, all data is for Tax Year 2006. Sources: IRS Form Instructions for Tax Year 2006; IRS Fiscal Year 2007 Data Book; Document 6961 (Calendar Year 2007 Projections); Document 6149 (Calendar Year 2007 Projections); and Document 6186 (Calendar Year 2007 Projections).